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AGENDA ITEM 7a

TO: MEMBERS OF THE INVESTMENT COMMITTEE

- I. SUBJECT:** Emerging Manager Fund-of-Funds RFP
- II. PROGRAM:** Global Equity
- III. RECOMMENDATION:** (1) Staff requests approval to issue a Request for Proposal (RFP) with a "Spring-Fed Pool" feature for emerging manager fund-of-funds, a new program at CalPERS. Staff will seek Investment Committee approval for the entire recommended group of fund-of-fund managers. Wilshire Associates' opinion letter is shown in Attachment 1.
- (2) Staff is providing an informational update on the Fund-of-Emerging Hedge Funds program in the Risk Managed Absolute Return Strategies Program (RMARS). This is another new program for CalPERS.
- IV. ANALYSIS:**

Executive Summary

This is an action item seeking approval for staff to conduct an RFP for managers of emerging fund-of-funds specializing in long-only U.S. and non-U.S. equity strategies. This RFP will enable CalPERS to create a new program targeting emerging managers in global equity, which will complement CalPERS' existing Manager Development Program I and II (MDP I & II). CalPERS' MDP I and MDP II program targets small and emerging investment management firms and obtains an equity stake in each firm that is selected, however in the fund-of-funds program CalPERS would not take an equity stake in the underlying managers.

The program would target emerging investment firms, with assets under management of less than \$2 billion at the time of selection, whose primary focus is long-only public equity. The fund-of-funds program would invest opportunistically and would complement the \$2.5 billion invested in emerging managers in the MDP I program and the additional allocation in MDP II which will be invested on an opportunistic approach. CalPERS staff has contracted with Mosaic Investment Advisors, one of CalPERS' diversity consultants, for the development of the fund-of-

fund strategy recommended in this agenda item, and will continue to work with Mosaic throughout the entire RFP process.

In addition, this agenda item provides an informational update on the fund-of-emerging hedge funds in the RMARS. Staff will work closely with Mosaic in implementing the fund-of-emerging hedge funds strategy in the RMARS as well.

Long-Only Fund-of-Emerging Managers

Background

The emerging fund-of-funds strategy will enable CalPERS to expand the opportunity set within the emerging manager universe since the fund-of-funds manager(s) will be able to select managers that would not be ideal candidates for MDP II because they do not need additional working capital or business assistance. This program will enable CalPERS to consider a large number of opportunities without requiring significant additional staff resources since the manager(s) of the fund-of-funds will be responsible for the majority of the manager selection and monitoring. It is also anticipated that, because there is no venture component, both the due diligence process and the funding process will be less time consuming.

The Investment Committee will be asked to vote on the entire recommended pool of fund-of-fund manager(s), rather than on individual fund-of-funds manager(s). The RFP will stipulate that the Investment Committee may decide to interview finalists at its discretion. The decision on whether to conduct Investment Committee interviews can be made at the time staff presents its recommendation on the group of fund-of-funds manager(s) to include in the pool.

Why an RFP is Needed

CalPERS currently has two Manager Development Programs, the MDP I, which is closed to new investments, and the follow on Program, MDP II, which targets small and emerging firms, (i.e., firms having less than \$2 billion of assets under management), that invest in long only public equity, high-yield fixed income, and emerging hedge fund-of-funds. All firms selected for MDP II receive investment assets, and in exchange for an equity stake, venture capital. Accordingly, MDP II firms will be in different phases of the investment firm cycle, ranging from pure start-up (early stage) to more mature firms (later stage), though most will be the early and mid-stage firms.

The emerging fund-of-funds program will also target small and emerging firms with assets under management of \$2 billion or less investing in long only public equity strategies. Because firms in this target group have progressed to the point that they

are not seeking additional working capital, it is expected that these firms will be in the later, more mature stage of the investment firm life cycle. Taken together, the emerging fund-of-funds and the MDP II will allow CalPERS to tap into a very broad spectrum of small and emerging firms.

Additionally, the venture component of the MDP II program is more labor intensive, thus each MDP II partner typically focuses on only one or two firms at a given time. Therefore, the number of firms selected to the MDP II program each year is relatively small. An emerging manager fund-of-funds will enable CalPERS to invest in a larger number of emerging managers more quickly.

Staff has outlined below the key differences between the MDP II program and the emerging manager fund-of-funds program. The equity stake and investment allocation component of the programs is the key differentiation between the two programs that would eliminate any potential conflicts between the two programs competing for the same investment opportunity.

Component	MDP II	Fund-of-Funds
Program Allocation	Opportunistic	Opportunistic
Investment Charter	Long-only public equity, high yield, and emerging hedge fund-of-funds	Long-only public equity
Equity Stake	Yes	No
Manager Selection	Staff and MDP Partners	Fund-of-Fund Manager*
Manager Termination	Staff and MDP Partners	Fund-of-Fund Manager**
Manager Allocation	\$75 - \$100 million	< \$50 million
Due-Diligence Process	60-90 days	< 30 days

**Staff will be involved to the extent that each Fund-of-Fund manager's underlying portfolio has minimal manager overlap. **The fund-of-fund manager will be required to provide CalPERS staff with written justification for all manager terminations and/or manager reallocations prior to implementation.*

Staff has contracted with Mosaic Investment Advisors, one of CalPERS' diversity consultants, to provide assistance to staff in developing the emerging fund-of-funds strategy, and will continue to work with Mosaic throughout the entire RFP process. Mosaic's input has been incorporated into this proposed fund-of-funds program.

Manager Search Process

The initial scoring of the proposals will be based on the fund-of-funds managers' responses to the RFP. Following the scoring of the RFPs, fund-of-funds managers with the highest scores will receive an on-site interview by CalPERS. After the interviews, staff will recommend to the Investment Committee a group of fund-of-funds managers that would make up the initial pool. The Investment Committee can decide to interview finalists at the time the recommendation is made.

The following criteria will be used for fund-of-funds manager selection:

- Performance in identifying emerging managers
- Experience with selecting emerging managers and structuring emerging manager fund-of-funds
- Sourcing emerging managers
- Assessing an emerging manager's investment capabilities
- Assessing the emerging manager's business and operational capabilities
- Effectively monitoring the emerging managers' portfolios
- Developing a relationship with the emerging managers
- Properly allocating capital among emerging managers
- Competitive fee structures

In consideration of the Board's policy on Board scoring, staff recommends that 200 points be allocated for staff (not including fees) and 200 points be allocated for the Investment Committee, to be applied in the event that the Committee decides to interview and score the bidders. The 200 points allocated to staff will consist of 100 points allocated to the scoring of the bidders' proposals and 100 points allocated to staff's onsite visits or interviews. Staff will seek input from Wilshire and from Mosaic Investment Advisors, one of CalPERS' diversity consultants, for the development of the questionnaire to be used in the scoring of the bidder's proposals.

Benefits of a Spring-Fed Pool of Managers

Staff recommends that the contracts be awarded through a Spring-Fed Pool process as a better way to include all eligible managers. This means that additional fund-of-funds managers may be considered after the initial RFP and funding. As time goes on, new proposals will be considered on a periodic basis using the same criteria and analysis used to select the initial group of fund-of-funds managers for additional funding. Fund-of-funds managers demonstrating the appropriate skills would then be brought to the Investment Committee for review and approval. The term of the Spring-Fed Pool would be five years.

Annual Review Contracts

Staff recommends the use of annual review contracts, which provide for an undefined duration, for this RFP. This would be consistent with the contracting procedure used for all other investment management contracts. This recommendation is necessary to fulfill CalPERS' fiduciary duties to its members because the use of annual review contracts is a more efficient use of CalPERS staff and board time and other resources. The award of contracts without a defined duration is allowed under Board Resolution 92-04B-4.

Emerging Fund of Funds Program Conclusion and Summary

- Issuing an RFP for this new emerging manager fund-of-funds program will allow CalPERS to expand the opportunity set within the emerging manager universe in global equity and shorten the time frame to fund these managers.
- The emerging fund-of-funds strategy will complement the \$2.5 billion invested in emerging managers in the MDP I program and the additional allocation in MDP II which will be invested on an opportunistic approach.
- A Spring-Fed Pool feature is requested in the contracting process in order to facilitate the re-allocation of the portfolio in the future, as well as the inclusion of new fund-of-funds managers who may qualify at a later date.
- Staff will seek Investment Committee approval for the entire recommended group of fund-of-funds managers. The Investment Committee can decide to interview finalists at the time the recommendation is made.
- Staff has contracted with Mosaic Investment Advisors, one of CalPERS' diversity consultants, to assist in the implementation of the emerging manager fund-of-funds program.

Update on the Fund-of-Emerging Hedge Funds in the RMARS Program

The Risk Managed Absolute Returns Strategies Program (RMARS) is currently evaluating advisors to construct customized funds of emerging hedge funds. Staff is following the same process used in the searches for its Asian and European fund of funds mandates. However, due to the unique nature of an emerging-manager program, the balance between qualitative and quantitative elements is shifted more heavily toward the qualitative side than was the case for the Asian and European searches. Because emerging hedge funds tend to have short track records (if a track record exists at all), qualitative factors take a larger role in assessing a prospective emerging hedge fund, with quantitative factors becoming more relevant as the emerging hedge fund executes its investment strategy and produces investment returns.

In order to maximize the probability of success for the funds of emerging hedge funds program, staff is seeking advisors with a unique and diverse skill set. Each advisor will have experience in the following:

- Performance in identifying emerging hedge fund managers
- Sourcing emerging hedge funds
- Assessing an emerging hedge fund's investment capabilities
- Assessing the emerging hedge fund's business and operational capabilities

- Negotiating terms commensurate with the risks of a “start-up” fund
- Developing a relationship with the emerging hedge fund manager
- Effectively monitoring the emerging hedge fund
- Properly allocating capital among emerging hedge funds

These characteristics are not unique to funds of emerging hedge funds advisors, but to be considered a candidate to run a portfolio for the RMARS Program, the advisors have to demonstrate they have the personnel, systems, and other resources required to satisfy the needs represented by each characteristic specifically with respect to emerging hedge fund managers.

Mosaic will assist CalPERS staff and its advisors in this endeavor by: 1) providing the advisors with prospective emerging hedge funds, and 2) providing guidance to emerging firms that need assistance in managing their business or in navigating the institutional investor marketplace.

V. STRATEGIC PLAN:

This item is consistent with the Strategic Plan: Goal VIII, manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions and Goal IX, achieve long-term, sustainable risk adjusted returns.

VI. RESULTS/COSTS:

The allocation to emerging manager fund-of-funds hired under this RFP will come primarily from global equity assets that are managed on a passive basis. Staff expects to fund 1 to 3 fund-of-fund managers with an initial allocation of \$1.0 billion to the overall emerging manager fund-of-funds program; however this allocation will be deployed on an opportunistic basis and subject to the success of the fund-of-fund firms. Current staffing within Global Equity is sufficient to complete this request for proposal.

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